

whose principal holdings mimic the performance of the stocks included in the stock index; or alternatively, while holding a portfolio composed of stocks that mimic the performance of the stocks included in the stock index.

[T.D. 8590, 60 FR 14638, Mar. 20, 1995]

§ 1.247-1 Deduction for dividends paid on preferred stock of public utilities.

(a) *Amount of deduction.* (1) A deduction is provided in section 247 for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on certain preferred stock (see paragraph (c) of this section). This deduction is an amount equal to the product of a specified fraction times the lesser of (i) the amount of the dividends paid during the taxable year by a public utility on its preferred stock (as defined in paragraph (c) of this section), or (ii) the taxable income of the public utility for such taxable year (computed without regard to the deduction allowed by section 247). The specified fraction for any taxable year is the fraction the numerator of which is 14 and the denominator of which is the sum of the corporation normal tax rate and the surtax rate for such taxable year specified in section 11. Since section 11 provides that for the calendar year 1954 the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, the sum of the two tax rates is 52 percent and the specified fraction for the calendar year 1954 is 14/52. If, for example, section 11 should specify that the corporation's normal tax rate is 25 percent and the surtax rate is 22 percent for the calendar year, the sum of the two tax rates will be 47 percent and the specified fraction for the calendar year will be 14/47. If Corporation A, a public utility which files its income tax return on the calendar year basis, pays \$100,000 dividends on its preferred stock in the calendar year 1954 and if its taxable income for such year is greater than \$100,000 the deduction allowable to Corporation A under section 247 for 1954 is \$100,000 times 14/52, or \$26,923.08. If in 1954 Corporation A's taxable income, computed without regard to the deduction provided in section 247, had been \$90,000 (that is, less than the amount of

the dividends which it paid on its preferred stock in that year), the deduction allowable under section 247 for 1954 would have been \$90,000 times 14/52, or \$24,230.77.

(2) For the purpose of determining the amount of the deduction provided in section 247(a) and in subparagraph (1) of this paragraph, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility stated that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may, however, include the dividends paid with respect to the current taxable year in computing the deduction under section 247. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may include the dividends paid with respect to a prior taxable year which ended after October 1, 1942, in computing the deduction under section 247; such public utility in addition may include the dividends paid with respect to the current taxable year in computing the deduction under section 247. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility may not include any distribution in the current year in computing the deduction under

section 247 to the extent that there are dividends unpaid and accumulated with respect to taxable years ending before October 1, 1942.

(3) If a corporation which is engaged in one or more of the four types of business activities (called utility activities in this section) enumerated in section 247(b)(1) (the furnishing of telephone service or the sale of electrical energy, gas, or water) is also engaged in some other business that does not fall within any of the enumerated categories, the deduction under section 247 is allowable only for such portion of the amount computed under section 247(a) as is allocable to the income from utility activities. For this purpose, the allocation may be made on the basis of the ratio which the total income from the utility activities bears to total income from all sources (total income being considered either gross income or gross receipts, whichever method results in the higher deduction). However, if such an allocation reaches an inequitable result and the books of the corporation are so kept that the taxable income attributable to the utility activities can be readily determined, particularly where the books of the corporation are required by governmental bodies to be so kept for rate making or other purposes, the allocation may be made upon the basis of taxable income. No such apportionment will be required if the income from sources other than utility activities is less than 20 percent of the total income of the corporation, irrespective of the method used in determining such total income.

(b) *Public utility.* As used in section 247 and this section, public utility means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy, gas, or water if the rates charged by such corporation for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. If a schedule of rates has been filed with any of the above bodies having

the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The deduction provided in section 247 will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (1) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region in one or more States, or from the operation of more than one such system and (2) that the regulation to which it is subject in part of its operating territory in one such system is effective to control rates within the unregulated territory of the same system so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(c) *Preferred stock.* (1) For the purposes of section 247 and this section, preferred stock means stock (i) which was issued before October 1, 1942, (ii) the dividends in respect of which (during the whole of the taxable year, or the part of the taxable year after the actual date of the issue of such stock) were cumulative, nonparticipating as to current distributions, and payable in preference to the payment of dividends on other stock, and (iii) the rate of return on which is fixed and cannot be

changed by a vote of the board of directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the deduction provided in section 247 shall not be denied in the case of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial for the purposes of section 247 and this section whether the stock be voting or nonvoting stock.

(2) Preferred stock issued on or after October 1, 1942, under certain circumstances will be considered as having been issued before October 1, 1942, for purposes of the deduction provided in section 247. If the new stock is issued on or after October 1, 1942, to refund or replace bonds or debentures which were issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), such new stock shall be considered as having been issued before October 1, 1942. If preferred stock is issued to refund or replace stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942, to refund or replace stock which was issued before October 1, 1942, and which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), is not itself preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), no stock issued to refund or replace such stock can be considered preferred stock for purposes of the deduction provided in section 247.

(3) In the case of any preferred stock issued on or after October 1, 1942, to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding

provision of the Internal Revenue Code of 1939), only that portion of the stock issued on or after October 1, 1942, will be considered as having been issued before October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942, shall be earmarked in determining the deduction allowable under section 247, but the appropriate allocable portion of the total amount of dividends paid on such stock will be considered as having been paid on stock which was issued before October 1, 1942.

(4) The provisions of section 247(b)(2) may be illustrated by the following example:

Example. A public utility has outstanding 1,000 bonds which were issued before October 1, 1942, and each of which has a face value of \$100. On or after October 1, 1942, each of such bonds is retired in exchange for 1 1/10 shares of preferred stock issued on or after October 1, 1942, and having a par value of \$100 per share. Only 10/11 of the dividends paid on the preferred stock thus issued in exchange for the bonds will be considered as having been paid on stock which was issued before October 1, 1942. Likewise, if preferred stock which is issued on or after October 1, 1942, has no par value but a stated value of \$50 per share and such stock is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of \$100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued before October 1, 1942.

(5) Whether or not preferred stock issued on or after October 1, 1942, was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new preferred stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures,

or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to consider the entire transaction, including the issuance of the new preferred stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued before October 1, 1942, issues new preferred stock on October 1, 1954, in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on November 1, 1954, such stock may be considered as having been issued to refund or replace bonds issued before October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(6) Preferred stock issued on or after October 1, 1942, by a corporation to refund or replace bonds or debentures of a second corporation which were issued before October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued before October 1, 1942, if such new stock was issued (i) in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939; or (ii) in a transaction to which section 371 (relating to insolvency reorganizations), or

the corresponding provisions of the Internal Revenue Code of 1939, is applicable; or (iii) in a transaction which is subject to the provisions of Part VI, Subchapter O, Chapter 1 of the Code (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission) or to the corresponding provisions of the Internal Revenue Code of 1939. Whether the stock actually was issued to refund or replace bonds or debentures of the second corporation issued before October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939, in a transaction to which section 371 or the corresponding provisions of the Internal Revenue Code of 1939 is applicable, or in a transaction which is subject to the provisions of Part VI, Subchapter O, Chapter 1 of the Code, or to the corresponding provisions of the Internal Revenue Code of 1939. The provisions of this paragraph, in addition, are applicable in case a corporation issues stock on or after October 1, 1942, to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated above.

(7) Even though stock issued on or after October 1, 1942, is considered as having been issued before October 1, 1942, by reason of having been issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, such stock will not be deemed to be preferred stock within the meaning of section 247(b)(2), and no deduction will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 247(b)(2) and in this paragraph.